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Rebalancing the Economy and Reforming the Fiscal System of the People's Republic of China

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Following the 19th National Congress of the Communist Party of China in October 2017, the 13th National People's Congress (the national legislature of the People's Republic of China [PRC]) and Chinese People's Political Consultative Conference were held in March 2018. The National People's Congress amended the Constitution, endorsed a government reorganization, laid out an economic and social program meant to move toward achieving the goals of high-quality and cleaner economic growth, and adopted a focus on human well-being and reduced disparities within the PRC. The State Council's "Report on the Work of Government" provided considerably more detail on the goals and objectives of the program but stopped short of identifying most of the specific policy interventions that are to come.²

The fact that about 85% of all government expenditures in the PRC pass through provincial

and local government budgets makes it clear that reforms in the intergovernmental fiscal structure will play a role in this program. The goal in this note is to lay out and discuss a package of reforms that could be consistent with the objectives of the government. The fiscal instruments that we consider here include the division of expenditure responsibilities, subnational government taxation, intergovernmental transfers, user charges, borrowing powers, and financial management practices.

Why a Change in Government Policy?

The performance of the PRC's economy has been the envy of the world during the past three decades. Real gross domestic product (GDP) increased 10% per year over three consecutive decades,

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² People's Republic of China (PRC). 2018. *Report On The Work Of The Government*. Speech delivered by Li Keqiang, Premier of the State Council, at the First Session of the 13th National People's Congress. 5 March; and E. Ahmad, I. Neuweg, and N. Stern. 2018. *China, The World and the Next Decade: Better Growth, Better Climate*. London: Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy, London School of Economics and Political Science.

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tax revenues increased from 10.6% of GDP in 1994 to 21% in 2016, infrastructure was modernized, and nearly 500 million people were lifted out of poverty. Large cities in the PRC even have income levels comparable to some member countries of the Organisation for Economic Co-operation and Development.³

But rapid economic growth and urbanization have also brought challenges. The growth rate of the PRC's economy is expected to slow by 2020, which will limit the fiscal surplus needed to address expenditure needs, including environmental protection, social security costs, and the provision of infrastructure and basic services. In addition, urbanization, which has already brought 260 million migrants from rural areas, will continue to swell the size of cities over the next decade. This will further increase the demand for housing, public infrastructure, and local public services. Most of the burden for providing these services will fall on provincial and local governments.

In addition, the government sees the goal of sustainable long-term growth as calling out for a rebalancing of the economy with more emphasis on increased private investment and productivity, more innovation, adoption of new technologies, removal of barriers that hold back efficient allocation of resources, greater concern for an improved quality of life, increased density in city populations, a reduction in regional inequalities, poverty alleviation, and meeting the needs of an aging population. Achieving these goals will require not only funding but some sweeping institutional changes. The State Council has already called for a large number of important reforms in the public sector delivery system and in its incentive package for private sector economic development.

The government plans to increase expenditures (particularly for social services) and the flow of transfers to subnational governments, and pledges to keep the fiscal deficit low. But on the revenue side, the emphasis seems to be on cuts in taxes, user charges, and government administrative fees, with the goal of stimulating economic activity and growing the tax base. There is an intention to introduce a property tax, but little else by way of proposed new tax actions. The risks inherent in the

intergovernmental fiscal system, notably borrowing by subnational governments, are being addressed by regulation on requirements for the issuance of new debt rather than by instituting a hard budget constraint on subnational governments. So, at this point, the likely changes in the institutional structuring for delivering services and financing them are more speculative than they are based on government announcements.

Possible Changes in the Intergovernmental Fiscal Structure

Certain possible reforms in the intergovernmental fiscal structure are consistent with the objectives of high-quality economic growth and the improvement of human well-being in the PRC. Some of these changes would involve more fiscal decentralization and some would lead to more fiscal centralization. Most are in the mode of offering subnational government leaders more autonomy in choosing their fiscal strategy but with incentives to make choices that are consistent with central government objectives. An alternative approach to sweeping institutional change would be to maintain the present intergovernmental fiscal structure and meet the desired objectives with mandates on service levels, as well as direct interventions in the expenditure regime such as conditional transfers or changes in budgeting practices.

Reassign Expenditure Responsibilities

The PRC is probably the most decentralized country in the world in terms of the expenditure responsibility it assigns to subnational governments. About 85% of all government expenditures are accounted for in subnational government budgets. This is twice the level in decentralized countries such as Canada and the United States. Best international practice and even intuition would seem to suggest that this share of central government is too small to accommodate expenditures with redistributive goals, or on social protection, or services characterized by significant externalities. Both internal and external students of Chinese economic policy have called out this issue.⁴

³ World Bank and the Development Research Center of the State Council, the People's Republic of China. 2014. *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*. Washington, DC: World Bank.

⁴ J. Lou. 2013. *Rethinking of Intergovernmental Fiscal Relations in China*. [In Chinese]. Beijing: Financial and Economics Publishing House; J. Martinez-Vazquez and B. Qiao. 2011. Assessing the Assignment of Expenditure Responsibilities. In J. Man and Y-H. Hong, eds. *China's Public Finance in Transition*. Cambridge, MA: Lincoln Institute of Land Policy, pp. 21-40; and footnote 3.

The PRC follows an unusual policy of assigning responsibility for social insurance, including pensions and health, to the lowest-level subnational governments. As often argued, this level of decentralization may not be sustainable for all social insurance functions because of the high level of risk pooling required and redistribution considerations.⁵ Moreover, portability of benefits (i.e., structuring common job benefits such that they are not tied to a specific employer or location) could make the spatial allocation of labor and investment more efficient. Some degree of provincial sharing is already underway, but a final solution, perhaps one that features full centralization of financing, is probably some years away.

A longstanding problem with expenditure assignments in the PRC is the overlap between the roles of the government and the market in allocating factor resources. Subnational governments allocate significant funds to state-owned enterprises (SOEs), in some cases competing with the private sector, and the number of locally owned SOEs has been growing. The opportunity cost of these subsidies is an increased level of local public services or a reduction in taxes, and a result of propping up unprofitable enterprises is a less efficient allocation of resources and perhaps a drag on the economy. The problem has been exacerbated by the use of public enterprises as a channel for issuing new bonds, risking unsustainable debt levels. A reasonable reform that has long been embraced by the central government is for subnational governments to begin shedding themselves of ownership of SOEs, as was mandated by the State Council in 2005. The State Council again in 2014 called for a clearer separation between the market and government and an end to preferential subsidies.

Finally, the complexity of regional development requires the central government's direct involvement. Particularly in areas such as transportation, pollution control, and water resource management, the benefits and costs associated with public service delivery spill over the boundaries of even large metropolitan governments, as evidenced

by discussions about creating “mega regions” with more authority over planning. Important examples include regional planning and service delivery in the Beijing–Tianjin–Hubei urban region and the Yangtze River Economic Belt, and in integrated water resource management and eco-compensation for the Yangtze River. The implementation of such regional plans is constrained because expenditure assignments are unclear and incentives for interregional cooperation are not in place. The need to connect cities within regions and within the country therefore requires significant central intervention.

Intergovernmental Transfers

The PRC's approach to intergovernmental transfers has fit well into its investment-led economic growth strategy. The present system has two major components. The first is a derivation-based revenue sharing system that provides a strong incentive to invest in infrastructure that will attract industry and expand existing enterprises.⁶ The second is conditional (earmarked) grants that are aimed at supporting the lagging regions and compensating those that have been harmed by national policies. Virtually all revenues of provincial and local governments come from these sources.

The revenue sharing system is financed using a fixed percentage claim on central government tax revenues that is transferred to provinces. It is an entitlement program of sorts for subnational governments, even though the sharing rates are frequently changed by the central government. The distribution among provinces is determined by point of collection of the revenues. The derivation-based system has supported the economic development goals of the state, and has helped stimulate revenue mobilization, especially in coastal regions. It has been reinforced by a reward system for appointed subnational government officials that favors economic development investments over human capital investments.

The conditional grants system is complicated by significant compliance and administrative costs. While it once included over 200 different grant

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⁵ R. Bahl, C.-C. Goh, and B. Qiao. 2014. *Reforming the Public Finance System to Fit a More Urbanized China*. [In Chinese and English]. Beijing: Financial and Economic Publishing House; R. Bahl and J. Martinez-Vazquez. 2006. *Fiscal Federalism and Economic Reform in China*. In J. Wallack and T.N. Srinivasan, eds. *Federalism and Economic Reform: International Perspectives*. Cambridge UK: Cambridge University Press, pp. 249–300; Y. Liu, J. Martinez-Vazquez, and B. Qiao. 2014. *Falling Short: Intergovernmental Transfers in China*. *Public Finance and Management*. 15 (4). p. 374; and footnote 3.

⁶ A derivation-based tax sharing system is one where the amount in transfers received by a region is proportionate to the share of taxes collected there. A discussion of the pros and cons of derivation-based tax sharing can be found in R. Bahl and R. Bird. 2018. *Fiscal Decentralization and Local Finance in Developing Countries: Development From Below*. Cheltenham, UK: Edward Elgar Publishing. Chapter 7.

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programs, this number has recently been declining and the State Council called for further reductions in 2018. Conditional grants account for about one-third of total subnational government expenditures.

But the present system for intergovernmental transfers is not in step with the new economy that is envisaged for the PRC. There are three major concerns. First, the incentives in the present system lean toward economic development spending at the expense of investment in social services. Second, the prospect that shares of value-added tax and income tax collections from existing enterprises will continue may discourage investment in newer plants and facilities and therefore slow productivity growth. Third, derivation-based revenue sharing runs contrary to the goals of fiscal equalization. Provinces with a higher per capita GDP receive significantly larger per capita amounts of shared tax transfers.

Neither do conditional grants fit the new development strategy, in part because they are costly to comply with and their effectiveness is uncertain. As mentioned, they are increasingly in decline.

The objectives of the government include formulating a plan for reforming the division of revenues and improving the transfer payment system, but no details have yet been given. In this respect, two basic strategies might be considered. The first is to patch up the present system to better fit the new economic and social goals, and postpone comprehensive reform to a later period. This might be done in a number of ways, including the following:

- Establish a new, more effective equalization grant that channels more funds to poorer regions. The grant might be funded by a reduction in the percent share of central tax revenues in the vertical pool for general revenue sharing, and/or a further reduction in conditional grants. More equalization might also be achieved by reassigning responsibility for social security expenditures to the central government level.
- The incentive system for appointed government officials might be revisited to reward social benefit spending and environmental controls.

- Performance grants might be introduced to reward provinces where the provisions of the new budget law are more fully implemented.

The other approach is to move toward an intergovernmental transfer system that better fits the new strategy for economic and social development. One possibility would be to replace derivation-based sharing with a formula grant distribution. This would both remove the bias against social service spending—since the amount of revenue received would no longer be linked to the amount of revenue collected—and open the door for creating a more equalizing system. The latter could be accomplished by making the distribution formula needs-based. It would also make local officials more open to the idea of abandoning less efficient SOEs. However, a needs-based grant system, if it were not accompanied by new local taxation powers, would weaken the incentives for increased revenue mobilization.⁷

Both approaches to restructuring the intergovernmental transfer system would impose significant transition costs and would need to be phased in. Moreover, both would result in a redistribution of revenues. Some provinces would be winners, raising the question about how to properly absorb the new revenues, while some would be losers, raising the question about how to fill the ensuing revenue gap.

Local Government Revenues

Local governments in the PRC have no taxation powers. All revenues are derived from shares of central government taxes. However, the economic and social program presented by the State Council in 2018 may open some new doors. The central government has committed to reviewing the revenue powers of subnational governments and has announced that it plans to introduce legislation to enable local property taxation in 2018.

The case for autonomous local taxation in the PRC would seem a good one, at least in the larger cities, and it is in step with the economic and social policy program of the government. In many cases, urban public service levels are better than in the rest of the country and urban income levels are higher, so paying a higher tax price in cities could

⁷ R. Bahl, C-C. Goh, and B. Qiao. 2014. *Reforming the Public Finance System to Fit a More Urbanized China*. [In Chinese and English]. Beijing: Financial and Economic Publishing House.

be an efficient and equitable solution. Such an arrangement might be seen as a kind of quasi user charge for urban public services.

There are good options for local government taxes in the PRC, particularly in provincial cities and large metropolitan areas. Property values have grown and this is likely to continue with more urbanization. Additional revenues from an annual tax on property values could easily contribute another 1% of GDP. Other property-related financing instruments could be revenue productive, including property transfer taxes and various forms of value capture.⁸ But success with land and property taxation in the PRC will depend on the kind of taxation the government decides on, which has not been announced yet.

Another option is to impose significant new taxes on the ownership and use of motor vehicles. The number of motor vehicles is growing faster than the population in the PRC and this imposes an infrastructure cost and external costs associated with congestion and pollution. Taxes on motor vehicles might be a way to reduce or recapture some of these heavy external costs. This might be done with increased tax prices on motor fuels in large cities, significantly higher motor vehicle registration fees in urban areas, tolls, and parking charges.

The largest metropolitan local governments might even be able to impose a broad-based income or sales tax, as is done in many Organisation for Economic Co-operation and Development countries. This might be done by piggybacking on the base of the central government tax with each local government given some authority to set a rate within certain limits (footnote 7). Such an arrangement could be revenue productive depending on the rate chosen. The administration would remain with the central government. The piggyback tax might be viewed as a charge for services received in an urban area, and it could be a way to make local leadership more accountable to the local population.

If the intergovernmental transfer system were restructured along the lines discussed above, as a needs-based grant, revenue “losers” could be compensated by authorization to impose certain local taxes. This might both ease the transition to a new transfer system and lead to more equalization

in the distribution of transfers. The end result would be a higher tax price paid by residents in urban areas for better quality services. Moving toward full cost recovery on traditional user charges could complement this approach. On the other hand, authorization for local governments to impose taxes or increase user charges might conflict with the supply-side approach to economic development advanced by the central government, which includes reductions in the taxes, user charges, benefit program contributions, and administrative fees that now burden businesses.

Borrowing

The PRC has long tried to accommodate the mismatch between the very restricted borrowing power of provincial and local governments and the heavy responsibility placed on them for financing infrastructure. To meet their capital financing needs, local governments have turned to agents who borrow on their behalf, known variously as “urban development investment companies (UDICs)”, “special purpose finance vehicles,” or “financing platforms”. UDICs are capitalized by the local governments, mostly with user rights to land that was purchased from rural collectives (farmers) and converted to state-owned status. The UDICs then borrow to finance the infrastructure improvements necessary to lease the land, using the expected revenue stream from the land leases as collateral. Half of the outstanding debt of subnational governments is borrowing by UDICs. According to draft financing components submitted to the World Bank in 2013, about two-thirds of this debt is guaranteed by the local governments (the guarantee status on the other one third is uncertain).

Because of the risks embodied in this approach, the budget law was revised in 2014 and 2015 to allow subnational government borrowing through the provincial governments, subject to the ceiling set by the central government and approval by provincial governments. However, much of this borrowing remains off-budget, with the result that quotas or limits can be circumvented, and contingent liabilities are not fully known. The revised budget law also included various policies to close “backdoors” and the central government tried to build a warning system to help local governments

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⁸ M. Smolka. 2013. *Implementing Value Capture in Latin America: Policies and Tools for Urban Development*. Cambridge, MA: Lincoln Institute of Land Policy.

The budget structure of subnational governments does not lend itself to objective analysis and evaluation of fiscal practices.

avoid an insolvency problem. But this reform, even though it goes in the right direction, does not significantly affect the borrowing incentive of local governments, and the “backdoors” have not disappeared as expected.⁹ In addition, it still leaves open the questions of where subnational governments will find the revenues to repay their loans, and what will happen if they do not repay them. At least in the case of cities, authorizing local governments to impose taxes could address the affordability issue of local government borrowing.

Financial Management Practices

In September 2014, the PRC’s legislature adopted a revision to the budget law, issuing directives to implement reform of the budget and management system. This marked the first revision to the law since 1995, a time when government policy was heavily influenced by planned economy concepts. Discussion in the PRC about “modernizing” the fiscal system was to a large extent about the abuse of power by subnational governments, and the new budget law was intended to address this issue.¹⁰

Local governments circumvent their hard budget constraints through ad hoc fiscal policies. This has been done by granting local firms preferential treatment via access to fiscal subsidies, tax exemptions, and credit, and by using SOEs as off-budget vehicles to finance public services or investments for higher GDP growth. These backdoor fiscal practices have been enabled by, among other things, an unclear boundary between the state and the market at the local level and may have been perpetuated by nontransparent financial reporting.

The budget structure of subnational governments does not lend itself to objective analysis and evaluation of fiscal practices. Subnational government budgets in the PRC have four accounts, or sub-budgets: the public finance budget (which is the general account), the government fund budget, the social security budget, and the SOE operating account. There is no consolidated budget that fully reconciles these accounts. In addition, separate off-budget accounts are kept for public service units, public enterprises, SOEs, and financing platforms. The financial records of sub-provincial government budgets have not been released since 2011.

Other issues have limited the full implementation of the State Council regulations. For one, the message from government about the use of off-budget sources of finance has not been clear. Neither has the practice of giving preferential tax treatments and rebates been eliminated. In 2015, the State Council put a hold on the elimination of existing preferential tax treatments due to growth slowdown and significant opposition to some of the regulations.¹¹

Though progress in implementing features of the new budget law have been stalled in some areas, the State Council regulations have set good directives for constraining subnational government budgets. They aim at improving the allocation of resources in ways consistent with the plan for higher quality development. Furthermore, they level the playing field between public sector and private sector investors, make budget decisions more transparent, and move the fiscal system a step closer to being rule-based.

⁹ Local governments in the PRC have a history of using “backdoor” approaches to financing infrastructure (i.e., finding ways around restrictive laws that limit their financing options). In the 1990s, they used extrabudgetary revenues and expenditures; in the 2000s, they borrowed through local corporations. In both cases, the central government waited some time before closing these backdoor approaches. This is explored further in R. Bahl, 1999. *Fiscal Policy in China: Taxation and Intergovernmental Fiscal Relations*. San Francisco, CA: 1990 Institute and University of Michigan Press; and C. Wong, 2013. *Paying for Urbanization in China: Challenges of China’s Municipal Finance in the Twenty-First Century*. In R. Bahl, J. Linn, and D. Wetzel, eds. *Government Finance in Metropolitan Areas in Developing Countries*. Cambridge, MA: Lincoln Institute of Land Policy. pp. 273–308.

¹⁰ For a discussion of the State Council regulations, and provincial reactions, see footnote 3 and R. Bahl, C.-C. Goh and B. Qiao, 2016. *Financial Management in Shandong Province*. [In Chinese and English]. Beijing: Financial and Economic Publishing House.

¹¹ Government of the People’s Republic of China, 2015. *Notice Regarding Certain Matters Related to Various Taxes and Other Preferential Policies (Guofa [2015] No. 25)*. Beijing.

Conclusions

The PRC has outgrown its intergovernmental fiscal system. While during the last 25 years, the incentives in place to support an investment-led economic development strategy were on the mark, the strategy of focusing resources on regions with the most growth potential was effective, and even the backdoor approaches to financing needed infrastructure accomplished important objectives, things have changed. The Chinese leadership envisions a new model of economic and social development with higher quality growth that will be more consumption- than investment-led; cleaner economic policies, with more innovation and adoption of new technologies; competition between public and private enterprises on a more level playing field; increased job opportunities; more emphasis on a higher quality of life for citizens; and less interregional disparity in access to good public services. The existing system of expenditure and revenue assignments, intergovernmental transfers, and subnational government borrowing may not be a good fit with this economic and social model.

In the short run, the PRC proposes to follow a supply-side macroeconomic fiscal policy that

will support GDP growth of about 6.5% in 2018. This will include about CNY800 billion in tax cuts; reductions in business payments for employee benefits, user charges, and administrative fees; and the removal of some government regulatory barriers to new business development and factor mobility. These reductions in the cost of doing business should stimulate and help rebalance the economy. On the expenditure side, significant increases in social services spending are proposed.

But the necessary reforms in the longer run will be much more difficult and will need to overcome well-entrenched positions on all of the pillars of intergovernmental fiscal relations—expenditure assignment, local government revenue mobilization, transfers, and borrowing. There is no single magic bullet for this. Virtually the whole of the intergovernmental system will need to be revamped to get PRC's public finances in sync with its new economic objectives.

This article was peer-reviewed by Ying Qian, Director, and Hans van Rijn, Principal Public Management Specialist, East Asia Public Management and Finance Division, Asian Development Bank.

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